Anatomy of a Franchise Lawsuit

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I. Default and Termination

A. Franchise Agreement

1. California Franchise Relations Act, Bus. & Prof. Code Section 20000 *et seq.*

a. Requires "good cause" for termination of a franchise agreement (§ 20020);

b. Requires that a franchisor give notice of default and an opportunity to cure of no more than 30 days before enforcing a termination of a franchise agreement (§ 20020);

c. But permits immediate termination without any opportunity to cure under specified conditions, *e.g.,* repeated breaches whether cured or not (§ 20021).

d. Exclusive remedy for violations of Act limited to franchisor's obligation to repurchase of inventory; no right to damages under Act for wrongful termination or refusal to renew franchise. *Boat & Motor Mart v. Sea Ray Boat*, *Inc.,* 825 F.2d 1285 (9th Cir. 1987).

2. Lanham Act 15 U.S.C. §1051 *et seq.* Trademark Protection

a. Infringement: Injunctions § 1116; profits, damages, attorneys fees and costs § 1117. Plaintiff need only prove sales, burden of defendant to prove offsets. Court may award treble damages in cases of intentional use of the mark.

b. Image and cleanliness violations as grounds for franchise termination: The trademark is the cornerstone of the franchise system. *Susser v. Carvel Corp.,* 206 F.Supp 636, 640 (S.D.NY 1962), *aff'd* 332 F.2d 505 (2d Cir. 1964), *cert. dismissed* 381 U.S. 125 (1965). That principle sparks the necessity of maintaining the standards of use and quality control that make the mark valuable. Protecting the mark is a practical necessity to the preservation of the franchise system; and it is a necessity under the Lanham Act to maintain the owner's rights in the mark. 15 U.S.C. § 1115(b)(2), 1127; *Haymaker Sports, Inc. v. Turian*, 581 F.2d 257 (C.C.P.A. 1978).

c. Quality control violations as grounds for franchise termination: The Lanham Act requires the holder of the mark to exercise quality control and otherwise control the use of the mark or lose the mark by abandonment. 15 U.S.C. § 1115, 1127. *Edwin K. Williams & Co. v. Edwin K. Williams & Co.-East*, 542 F.2d 1053 (9th Cir. 1976).

d. Trade Dress: Section 43(a) of the Lanham Act protects the trade dress of the franchisor's business. 15 U.S.C. § 1125; *Fuddruckers,*

Inc v. Doc's B.R. Others, Inc., 826 F.2d 837, 841-45 (9th Cir. 1987).

e. Issues regarding post-termination injunctions and necessity of showing irreparable injury and validity of termination. *McDonald's Corp. v. Robertson*, 147 F.3d 1301, 1308 (11th Cir. 1998) [requiring a showing of proper termination]; *Rodeo Collection LTD v. West Seventh*, 812 F.2d 1215, 1220 (9th Cir. 1987) [requiring independent showing of irreparable harm].

3. Drafting default notices

a. Specificity: clearly identify and set forth the contract provision at issue;

b. Specificity: clearly identify and set forth the conduct constituting the breach;

c. Specificity: clearly identify and set forth any cure rights, consequences of non-cure, post-termination procedures and trademark and service mark protection procedures.

d. Consider inclusion of non-waiver provision such as:

e. "This notice is given without waiving any prior or future defaults of your Franchise Agreement. In order to protect our Marks, names and System, we reserve the right to continue to transact business with you, accept royalty and other payments and otherwise support your operation until such time as you have compiled with the post-termination requirements of your Franchise Agreement and of this notice. This shall in no way constitute a wavier of this notice or any prior, future or other default notice or of our rights to obtain specific performance, injunctive relief, other such orders, damages and penalties or to otherwise enforce this or any other notice of default or termination."

B. Leases and Subleases: does the franchisor control the real property?

1. California Unlawful Detainer Law C.C.P. §§ 1159 *et seq*.

a. Like the Franchise Relations Act, also requires notice and opportunity to cure.

b. Cross-default provisions: shield and sword.

(1) Breach of franchise agreement may constitute breach of lease or sublease; breach of lease or sublease may constitute breach of franchise agreement

(2) Attempt to terminate franchise relationship by unlawful detainer proceedings **may** fail because the franchise agreement and the lease contain cross-default provisions or otherwise "are so inextricably intertwined" that it would be unfair to employ the UD summary remedy, in which affirmative defenses are precluded, to end the relationship. *E.S. Bills v. Tzucanow* (1985) 38 Cal.3d 824, 215 Cal.Rptr. 278 (allowed but reversed to allow presentation of affirmative defense); *Mobil Oil v. Rossi* (1982) 138 Cal.App.3d 256, 187 Cal.Rptr. 845.

(3) If franchise agreement includes arbitration clause, may require arbitration of default before summary UD remedy may be litigated in court. *Id.*

II. Actions between the Franchisor and franchisee

A. California Franchise Investment Law ("CFIL") Corp. Code §§ 31200 *et seq*.

1. Sections 31200, 31201 and 31202: Offer and sale of franchise involving any oral or written statement that contains "untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" unlawful;

2. Section 31110: Sale of unregistered franchise; *Neptune Society Corp. v. Longanecker* (1987) 194 Cal.App.3d 1233, 240 Cal.Rptr. 117.

3. Section 31111: Sale of registered franchise without disclosure statement.

4. Sections 31300 and 31301 create only private rights of action under CFIL (§ 31306).

Note: limitations on actions (§§ 31303 and 31304), affirmative defenses and remedies available are tricky.

5. Parties: § 31302**. "**Every person who directly or indirectly controls a person liable under Section 31300 or 31301, every partner in a firm so liable, every principal executive officer or director of a corporation so liable, every person occupying a similar status or performing similar functions, every employee of a person so liable who materially aids in the act or transaction constituting the violation, are also liable jointly and severally. . . ."

6. *Cf*. Common law fraud: is proof of reliance or reasonable and justified reliance a required element under the CFIL? *Galatolo v. Union Oil Co.* (N.D.Cal. 1980) CCH Bus. Fran. Guide ¶ 8179 at p. 14,473. In *California Bagel Company v. American Bagel Company* (C.D.Cal. 2000) CCH Bus. Fran. Guide ¶ 11,880 it was held that a showing of justifiable reliance was necessary under §§ 31300 and 31301 of the CFIL.

7. Disclaimer in UFOC that "our salesmen are not authorized to and do not make earnings claims" may be a violation itself. *FTC v. Minuteman Press, et al.* (E.D.N.Y. 1998) CCH Bus. Fran. Guide ¶ 11,516 at p. 31,260. However, in a private action under the CFIL, such statements may as a matter of law negate justifiable reliance. *California Bagel Company v. American Bagel Company* (C.D.Cal. 2000) CCH Bus. Fran. Guide ¶ 11,880.

8. Standard for rescission under the CFIL is "willful" conduct on part of franchisor, and under existing law, ignorance of the law or even reliance on advice of counsel may not be a defense. *See, e.g.*, *People v. Gonda*, 138 Cal.App.3d 774, 188 Cal.Rptr. 295 (1982).

B. Common Law Fraud

1. Parol Evidence Rule Code of Civil Procedure § 1856: "Terms set forth in a writing intended by the parties as a final expression of their agreement with respect to such terms as are included therein may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement."

a. Substantive and procedural rule. *Banco do Brasil, S.A. v. Latian,*

Inc. (1991) 234 Cal.App.3d 973, 1000, 285 Cal.Rptr. 870; *Ri Joyce, Inc. v. New Motor Vehicle Board* (1992) 2 Cal.App.4th 445, 452, 3 Cal.Rptr.2d 546.

b. "Fraud exception" to the Rule C.C.P. § 1856 (g): promissory fraud vs. fraud in the inducement. *Bank of America Nat. Trust & Savings Ass'n. v. Pendergrass* (1935) 4 Cal.2d 258, 259, 48 P.2d 659; *Price v. Wells Fargo Bank* (1989) 213 Cal.App.3d 465, 484, 261 Cal.Rptr. 735; *Vai v. Bank of America* 56 (1961) Cal.2d 329,344 ["when the agreement itself is procured by fraud, none of its provisions have any legal or binding effect"]. Current case law draws clear distinction between fraudulent promises that are at odds with the agreement and statements of fact, and apply parol evidence rule to bar admissibility of former. See, *Scott v. Minuteman Press International, Inc.,* (N.D. Cal. 1993) CCH Bus. Fran. Guide ¶ 10,344; *Carlock v. Pillsbury Co.,* 719 F.Supp. 791 (D.Minn. 1989); *Cook v. Little Caesar Enterprises, Inc*. 210 F.3d 653 (6th Cir. 2000); *Hobin v. Coldwell Banker Residential Affiliates, Inc*. (N.H.Sup.Ct. 2000) CCH Bus. Fran. Guide ¶ 11,781; *California Bagel Company v. American Bagel Company* (C.D.Cal. 2000) CCH Bus. Fran. Guide ¶ 11,880.

2. Corp. Code § 31512 of the CFIL: "Any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law or any rule or order hereunder is void." A recent case held that this anti-waiver provision was not applicable to the typical "integration" clause found in franchise agreements. *California Bagel Company v. American Bagel Company* (C.D.Cal. 2000) CCH Bus. Fran. Guide ¶ 11,880.

C. Breach of Implied Covenant of Good Faith and Fair Dealing

1. There can be no implied covenant where the subject is completely covered by the contract. *Carma Developers (Cal.), Inc. v. Marathon Development California, Inc.,* (1992) 2 Cal.4th 342, 6 Cal.Rptr.2d 467;

Third Story Music, Inc. v. Waits (1995) 41 Cal.App.4th 798, 804, 48 Cal.Rptr.2d 747

2.Territorial or Market Encroachment. While most jurisdictions have practically eliminated causes of action for breach of the implied covenant in encroachment cases (*Eichman v. Fotomat Corp.*, 880 F.2d 149 (9th Cir. 1989)) there may be some new vitality to the notion: *In re Vylene* 90 F.3d 1472 (9th Cir. 1996); *Foodmaker, Inc. v. Quershi, et al.* CCH Bus. Fran. Guide (Sup. Ct. San Diego, 1999) ¶ 11,780. The Internet will no doubt create interesting encroachment related issues. *See, e.g.*, *Emporium Drug Mart, Inc. of Shreveport v. Drug Emporium, Inc.,* CCH Bus. Fran. Guide (AAA., Dallas, TX 2000) ¶ 11,966.

D. Fiduciary Duty.

Absent special duties of trust, there is no fiduciary duty created by a distributorship or franchise agreement. *Rickel v. Schwinn Bicycle Co.* (1983) 144 Cal.App.3d 648, 192 Cal.Rptr. 732; *Premier Wine & Spirits v. E. & J. Gallo Winery*, 846 F.2d 537, (9th Cir. 1988). But, there could be fiduciary duties created whenever the franchisor assumes some control over franchisee funds, such as advertising funds.

E. Contracts of Adhesion.

Barney Motor Sales v. Car Sales, Inc. 178 F.Supp. 172, 174 (S.D. Cal. 1959); *Keating v. Superior Court (Southland Corporation)* 31 Cal.3d 584, 593, 183 Cal.Rptr. 360 (1982) (reversed on other grounds); *Postal Instant Press, Inc. v. Sealy* (1996) 43 Cal.App.4th 1704, 1716-1717, 51

Cal.Rptr.2d 365.

F. Damages.

Termination for failure to pay royalties may void right to obtain damages award for future lost royalties. *Postal Instant Press v. Sealy* (1996) 43 Cal.App.4th 1704, 51 Cal.Rptr.2d 365.

G. Covenants Not To Compete.

California law voids provisions in contracts which prohibit a party from competing. *See,* California Business & Professions Code §§ 16600 *et seq*. Post-termination covenants not to compete are generally not enforceable in California. *Scott v. Snelling and Snelling*, 732 F.Supp. 1034 (N.D. Cal. 1990). Non-competes given in connection with sale of goodwill are an exception to the rule, except the sale of a franchise has been held not to come within that exception. *Scott v. Snelling and Snelling*, *supra. But see, Snelling and Snelling v. Martin*, Bus. Fran. Guide (CCH) ¶ 11,384 (N.D. Cal. 1998), which upheld: 1) a lease assignment clause by which the franchisee was required to assign its lease to the franchisor in the event of termination; and 2) a right to purchase the assets of the business at a favorable price on termination.

However, if there is only a *partial* restraint, a non-compete may be enforceable. *Great Harvest Franchising v. Artim*, CCH Bus. Fran. Guide (E.D. Cal. 1997) ¶ 11,259 and *Great Harvest Franchising v. McKinley et al.,* CCH Business Franchise Guide (C.D. Cal., 1997). ¶ 11,260 [Covenant prohibited franchisees from baking wheat bread or rolls containing 25% or more whole wheat]. Those cases relied on *General Commercial Packaging v. TPS Package*, 114 F.3d 888 (9th Cir. 1997).

In-term covenants are treated differently and enforced on the theory that the person is not being prohibited from practicing his or her profession. *See, e.g.*, *Fowler v. Varian Associates, Inc.*, (1987) 196 Cal.App.3d 34, 44, 241 Cal.Rptr. 539; *Shaklee U.S. Inc. v. Giddens (Not for Publication),* 934 F.2d 324 (table), 1991 WL 90003, *3 (9th Cir. 1991), *cert. denied,* 502 U.S. 1033, 112 S.Ct. 876, 116 L.Ed.2d 781 (1992). *See, also, Adcom Express, Inc. v. EPK., Inc.*, Bus. Fran. Guide (CCH) ¶ 10,953 (Minn. Ct. Ap. May 21, 1996) (*Not for Publication)*; *Great Frame Up Systems v. Jazayeri Enterprises*, 789 F.Supp. 253 (N.D. Ill. 1992).

A franchisor will still be able to obtain relief to prevent the franchisee from *unfairly* competing, by, *inter alia,* using trade secrets, confidential information, or the franchisor's trademark. *See, e.g., Scott v. Snelling and Snelling*, *supra.*

H. Issues Surrounding Arbitration and Forum Selection Clauses.

Arbitration clauses in franchise agreements are generally enforceable, even if they are adhesion contracts. *Keating v. Superior Court (Southland Corporation)* (1982) 31 Cal.3d 584, 593, 183 Cal.Rptr. 360, reversed on other grounds, *Southland Corp. v. Keating*, 465 U.S. 1 (1984). Fraud in the inducement of the arbitration clause or in the inception or execution renders it voidable, but fraud in the inducement of the franchise agreement as a whole is not sufficient to avoid arbitration. *Rosenthal v. Great Western Fin. Securities Corp.* (1996) 14 Cal.4th 394; 58 Cal.Rptr. 2d 875. Courts retain the powers to refuse to enforce arbitration clauses when they are unconsionable or very one-sided. *See, e.g., Graham v. Scissor-Tail, Inc.* (1981) 28 Cal. 3d 807, 171 Cal.Rptr. 604; *Stirlin v. Supercuts, Inc.*, (1997) 51 Cal.App.4th 1519, 48 Cal.Rptr.2d 747.

Section 20040.5 of the California Business and Professions Code voids out of state forum selection clauses in franchise agreements. Such clauses have been held unenforceable to require transfer of litigation to another state. *Jones v. GNC Franchising, Inc.*, 211 F.3d 495 (9th Cir. 2000). *See, Wimsatt v. Beverly Hills Weight Etc. Internat., Inc.*, (1995) 32 Cal.App.4th 1511, 38 Cal.Rptr.2d 612 for standards for enforcing forum selection clause in franchise agreement not covered by section 20040.5.

Application of section 20040.5 to arbitrations in foreign states may be preempted by the Federal

Arbitration Act (9 U.S.C. §1 *et seq*.), which requires courts to enforce arbitration agreements according to their terms notwithstanding any contrary state statute or decisional law. *Southland Corp. v. Keating*, 465 U.S. 1 (1984); *Doctor's Assocs. v. Casarotto,* 517 U.S. 681 (1996). But because of language mandated by the California Department of Corporations to be inserted into offering circulars as to enforceability of arbitration clauses in franchise agreements, it has been held that there is no agreement as to locale to enforce. *Laxmi Investments, LLC v. Golf USA,* 193 F.3d 1095 (9th Cir. 1999). This lack of agreement as to locale could result in the court ordering arbitration in California, or deferring to the parties' agreement to abide by the decision of the arbitration provider. *See, e.g., Kim v. Colorall Technologies, Inc*., CCH Bus. Fran. Guide ¶ 11,922 (N.D. Cal. 2000).

In a recent decision which side-stepped the issue of federal preemption and applicability of section 20040.5, *supra*, the California Court of Appeal held that a forum selection clause that was imposed on an existing franchisee on renewal of the franchise agreement was unconsionable because the franchisee would lose substantial business by having to arbitrate in a far-away forum. *Bolter v Superior Court*, 01 C.D.O.S. 2044, __ Cal.App.4th __ (2001).

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